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South China Food Processing Report 2012

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Executive Summary: Stable economic development and urbanization are the trends fueling booming growth for processed food in the Mainland China market. In 2011, China's food processing industry was valued at \$1,239 billion, a 31-percent increase in value compared with the previous year. South China's food processing base reached \$62 billion in profits in 2011 ranking as the top three in the nation. This report provides in market intelligence and analysis on three food ingredient commodity areas: dairy, tree nuts and dried fruit products.

General Information:

Dairy products: In 2008, the China melamine-tainted powdered milk scandal impacted domestic dairy product prices on the whole, but these have been slowly recovering after years of poor sales performances. Nearing almost four years since the incident, a series of strong government and corporate campaigns have provided greater quality assurances and guarantees to suspicious consumers. Stricter quality controls, new regulations, and regular enforcement by local officials have forced many medium and small-sized dairy companies, which could not afford to invest in the types of machinery and techniques required by the nation authorities, to leave the dairy manufacturing industry.

Since the melamine crisis, consumers have increasingly opted for products from well-known and “trusted” manufacturers either international (if these consumers can afford them) which are perceived to offer better quality; or, “neighborhood” brands. For example, the average South and East China middle-class consumer will not only not purchase any type of *Mengnui* (蒙牛) or *Yili* (伊利) branded products in the retail sector, but they will boycott purchases in restaurants and other food service outlets. In certain regions of China, there remains a lack of trust and an image of corruption and low-quality associated with these two brands. Smaller “neighborhood” brands such as Guangxi Province’s *Huangshi* (皇氏) and Guangdong Province, Shantou City’s *Yashili* (雅士利) have capitalized on these lingering negative regional consumer perceptions of the major state-owned dairy manufactures and have launched regional food safety outreach campaigns geared at community residential areas located near their major production facilities and the neighboring suburban enclaves. They have been successful in differentiating their brands from the state-owned dairy manufacturing giants.

Furthermore in early 2011, the central government lowered the Mainland’s minimum protein standards for raw milk from 2.955 percent to 2.8 percent and quadrupled the permissible aerobic bacteria count from 500,000/ml to 2,000,000/ml, hoping to reduce the incentive for farmers and dairy producers to cheat milk collection centers by adding melamine or other chemicals. However, this new policy signaled to consumers that China’s milk production standards are decreasing instead of increasing in quality. Consumer confidence for domestic dairy products instantly decreased after this policy was announced.

Milk Powder: China has an unprecedentedly high demand for imported milk powder. Over half of China’s babies under six months rely on infant formula (and 20 percent continue to use it as a food supplement until age 3), which requires imported milk powder to produce. The catastrophic collapse of consumer confidence in domestic milk powder brought on by the 2008 melamine scandal has pushed some infant formula producers to rely exclusively on imported milk powder. Not surprisingly, brands produced with imported milk powder dominate first and second tier city markets and are perceived as high-end products by local consumers. Imported milk powder demand remains strong as it is the most important input for China-based processing of infant formula and other infant food products.

With combined imports above 500 million tons in 2011, **nonfat dry milk powder and whole milk powder** remain as China’s largest dairy imported product categories.

Fluid Milk: With a faster recovery in consumer confidence, locally-produced milk demand has largely returned to pre-2008 levels as it has been offset by rising incomes in tandem with strong consumer demand for higher protein diets. Overall food inflationary pressures in 2012 have driven fluid milk products to increase by 7 percent. Though 78 percent of fluid milk consumed in China is UHT (ultra

heat treated) milk, in first tier cities UHT milk accounts for about 68 percent of the fluid milk market. China's preference for UHT milk is driven by necessity as cold chain standards in many second tier cities lags behind first tier cities of Beijing, Guangzhou, Shanghai and Shenzhen. Fresh fluid pasteurized milk also enjoys 20 percent higher retail price over UHT milk.



Imported UTH milk in South China retail market (Source: ATO GZ)

The fluid milk segment also commands a substantially high-level government interest and support. In 2008, Premier Wen Jiabao's "I have a dream to provide every Chinese, especially children, sufficient milk each day" speech signaled the central government's support for efforts to promote nutrition by increasing the children's daily dairy consumption. In line with this pledge, the central government has actively controlled prices in fluid milk markets, requiring domestic dairy producers to submit applications to the National Development and Reform Commission (NDRC) before they can increase prices.

Moreover, on July 6, 2011, China's General Administration of Taxation announced plans to reduce the value-added tax (VAT) for pasteurized milk produced according to the national standard GB19645-2010, and UHT milk produced according to the national standard GB25190-2010 from 17 to 13 percent. The product lines have been reclassified as primary agricultural products. Meanwhile, processed flavored milk is not considered a primary agricultural product, so will continue being levied a 17 percent VAT. The lower prices were a message from the central government to reduce food inflationary pressures that could impact China's food security and political stability, but also to encourage a broader-base increase in national fluid milk consumption. In other words, the incentive encourages an increase demand for fluid milk consumption.

Whey: Whey is China's second largest imported dairy product with large ongoing demand due to higher valued food processing, infant formula production, and feed industry demand. In Jan-Aug, 2012, U.S. whey exports to China increase by 30 percent compared to the previous year. As a byproduct of cheese production, whey traditionally had a limited market value in the United States or in other major cheese-producing countries; however, China's increasing demand for whey powder as a main ingredient for infant formula has provided wider opportunities for U.S. cheese producers. With about 16 million babies born in South China each year, the demand for whey powder and milk powder imports is expected to continue to grow at a significant rate.

Cheese: Product awareness of cheese remains limited among local consumers, most of whom only know that mozzarella is a topping for pizza. Many consumers cannot accept the taste or smell of cheese or find it difficult to digest. Foreigners living in Mainland China and westernized locals make up a large portion of the niche market for cheese. However, with increasing availability of cheese products in the retail sector, sales of cheeses are rapidly growing from a small base in large cities. Imported cheeses are being marketed as health-conscious products to high-income consumers and are being incorporated into bakery products at a higher rate than previously used.

One value-added ingredient increasingly being used in the production of baked and processed foods is **cheese powder**. This input adds nutritional value (increased protein content) and enhances the flavors of finished products. U.S. cheese powder's low moisture content makes this product affordable to the local bakery chains as there is no need to refrigerate the product before they are cooked. Typical uses of cheese powder includes the production of biscuits, savory snacks, baked products, sauces, dips and dressings, ready meals, and even reconstituted cheese.

Most cheeses found in the retail market are imported from the United States, France, Denmark, New Zealand and Australia. A small amount of domestic cheese products are processed cheese slices manufactured locally by Kraft and Shanghai Bright. Some domestic brands either source ingredients from abroad or contract out foreign dairy factories to produce private label cheeses for the Chinese market. This is the case of the *Suki* brand which is a private label *Land O'Lakes* product produced for the Shanghai Gaofu Foods Company. Domestic dairy companies are eyeing private label cheese production from the United States and this is an opportunity for U.S. dairies to engage China's dairy producers.

In 2011, ATO Guangzhou launched a U.S. cheese media event, and in 2012, organized a South China U.S. dairy buyers' mission to California. Though more consumer education on the nutritional aspects of cheese is widely needed in the China market, traders and end-users could also benefit from greater activities by way of cooking demonstrations, trainings, and chef competitions.

Tree nut & dried fruit: The health and wellness trend is the most popular aspect adhered to by the local food processing industry. Economic development has brought about an improved quality of life, and college educated Chinese consumers are becoming more health consciousness as their incomes increase. Consumers pay closer attention to food safety, nutritional balance, natural raw materials, etc. Food processors used tree nut and dried fruit to give consumers to feeling that their products are natural, nutritious and wholesome. 80 percent of tree nuts and dried fruit are mainly consumed as snack food and the rest are used in bakery, confectionary and food services. Although China produces a variety of nuts and dried fruit domestically as well as has long history in processing these commodities (such as peanuts and sweet apricots), imported nuts and dried fruit have recently gained a foothold in the China market. In 2012 Jan-July, U.S. almonds and walnuts remained as the top imported tree nuts respectively accounting for 672 percent increase of shelled walnuts and 110 percent increase in shelled almonds compared to same period last year.

The Mid-autumn Festival and Lunar New Year are the two best seasons for the sales of imported tree nuts and dried fruit. Nuts and dried fruit are marketed in adorned gift packages to friends, clients, or other business associates. The first week of May and October are also peak tourist seasons for tourism. Middle class and young adults residing in China's first and second tier cities favor year-round tree nut

consumption. Though many still believe the myth that tree nuts are “hot” foods and that eating too much in the warm seasons will hurt one’s health, younger consumers as well as the emerging educated middle class lend greater credence to nutritional benefits supported scientific research rather than relying on conventional beliefs.

Pistachios: Last year, the United States exported \$42 million pistachios to China, a 37-percent increase due in part to a temporary low tariff policy effective since 2008, and the U.S. industry’s efforts in raising awareness for toxic food bleaching agents in China’s food processing sector. As a result, China’s Ministry of Health has tightened the policy of additives usage since early 2011, and hydrogen peroxide as a food bleaching agent has been removed from the additives list. This policy adversely impacted Iran pistachios given their lower quality darker yellow shell was bleached in the past to meet local consumers’ preferences. U.S. pistachio exports to China are expected to benefit from this new policy as the naturally whiter shell, larger size, and overall higher quality kernels are favored by local consumers.

Almonds: U.S. shelled almond exports to China reached \$67 million in 2012 due to its favorable price relative to other imported tree nuts. Price sensitivity remains the primary concern in China’s tree nut market. The Almond Board of California (ABC) has periodic contact with traders and media to ensure the end users and consumers understand the different varieties of the California crop as well as their health and nutritional features. ABC has devoted resources to develop distribution channels and relationships with all of the major national and regional chain stores. A series of marketing promotions were launched during the off-holiday season to strengthen sales and the relationship with retailers.

Walnuts: China’s annual domestic consumption of walnuts is largely due to its recognized nutritional and medicinal aspects associated with consuming this tree nut. Locals mainly consume walnuts as snacks via the retail sector and in side dishes or in baking ingredients via the food processing sector. Industrial manufacturers process walnuts into many other forms of food and drinks, such as cakes, biscuits, mixed nuts, walnut-flavored snacks and food, milk, oil, etc.

According to China Customs statistics, in 2011 U.S. walnut exports to China were valued at \$66 million, a 30-percent increase compared to 2010. Walnut consumption will maintain an upward trend, driven mostly by growing demand in the consumer market and food processing industries, with industrial processing channels accounting for a greater share in total consumption. The California Walnut Commission (CWC) played a strong role in developing the China market in terms of launching a chef competition, media promotion, trader gatherings and trade show participation.

Pecans: Pecans are the fastest growth commodity in the “other nuts” category. Before 2007, there was hardly U.S. pecans in China. However, the appetite for pecans exploded in 2007 when the price of walnuts soared, which made pecans a good substitute and at a great bargain. China's pecan boom is also because over the past decade China's emerging middle-class consumer base became increasingly keen on walnuts, and pecans bare some similarity to walnuts in taste and appearance, and consumers believed they have higher nutritional value than walnuts. In 2011, pecan prices stabilized to 2008 levels with large increases in annual import volumes.

Dried Peas: U.S. dried peas are widely consumed in China. According to industry researches, the retail market accounted for half of dried pea consumption and foodservice usage accounted for 10 percent of total consumption. U.S. dry peas are mainly used in preparing meals or soups in both sectors. A large

proportion, around 40 percent, of dried peas are reserved for industrial processing into canned peas and mixed vegetables, pea flour, and dried pea snacks. Processed and packed peas are consumed as snack foods and are displayed along with tree nut snacks in supermarket store shelves. Retail and foodservice consumption of dried peas is mature with steady growth. The improved living standards in China and increased food consumption have also stimulated demand for pea flour, directly leading to increased industrial usage of dried peas. Therefore, the industry forecasts in 2011-2013, jointly promoted by retail, foodservice and industrial channels, the consumption of dried peas will maintain a stable and upward growth trend. Many of the snacks made from U.S. peas that are currently being sold in retail channels were mainly manufactured Malaysia, the Philippines, Vietnam and Thailand. These products enjoy duty free access into the Mainland China market.

Prunes: U.S. prunes have a promising market in Mainland China. In fact, in 2012 China imported \$7.8 million in U.S. prunes, a 91-percent increase compared to 2011. U.S. prunes are mainly processed in South China's food processing bases of Shantou, Jiangmen, and Foshan. They are imported with pit and manually pitted in China, but as the labor cost increases, local manufactures are substituting workers with machines. Some large food processors have developed new product lines which have helped to expand the U.S. prune usage and remain competitive in the market. For example, U.S. prune moon cakes (pictured above) and prune favor biscuits. Product innovations and development remain the important factors for this commodity.

Raisins: U.S. dried fruit has been a dominant player last three decades of China's import dried fruit market; however, increased competition from South American producers have raised price sensitivity issues that not only impact growth, but threaten market share. U.S. producer associations have been strongly advised by ATO Guangzhou to take action manage this key market with greater trade servicing activities. In 2011, U.S. exported \$20 million-worth raisins to China, lower than industry forecasts as the bakery industry expansion and demand continue booming.

Prune moon cake. Source: ATOGZ



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